No. 78-700

In the Supreme Court of the United States

OCTOBER TERM, 1978

HERMAN AND MARY E. MCKINNEY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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The question presented in this federal income tax case is whether petitioner[1] is entitled to the special relief provisions of Section 1341 of the Internal Revenue Code of 1954 with respect to his repayment of embezzled funds included in income for an earlier year.

The pertinent facts are as follows: Petitioner embezzled $91,702.06 from his employer in 1966, and reported this amount as "miscellaneous income" on his federal income tax return for that year. The embezzlement was thereafter discovered, and petitioner was convicted of embezzlement in a state court. He repaid the embezzled funds in 1969. On his return for that later year, petitioner claimed a

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[1]References to petitioner are to Herman McKinney. His wife, Mary E. McKinney, is a party to this case solely because she filed a joint return with her husband for the year at issue.

deduction for the repayment as a loss incurred in carrying on a trade or business. This resulted in a claimed "net operating loss" for 1966, which petitioner sought to carry back to 1966. Alternatively, petitioner claimed entitlement to the benefit of Section 1341 for 1969 (Pet. App. 12a-13a). Under Section 1341, where a taxpayer repays an amount "included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item" and the deduction allowable for such a repayment would exceed $3,000, the tax for the year of repayment is the lesser of (1) the tax computed with such deduction or (2) the tax computed without such deduction reduced by the amount of tax paid for the earlier year (or years) attributable to the original inclusion of the amount in question in gross income. If such additional tax for the earlier year exceeds the tax for the repayment year, computed without a deduction for the repayment, the excess is treated as an overpayment for the latter year. See Treasury Regulations on Income Tax, Section 1.1341-1(i) (26 C.F.R.).

On audit, the Commissioner of Internal Revenue determined that petitioner's repayment of the embezzled funds was deductible only as a loss from a transaction entered into for profit under Section 165(c)(2) and not as a business expense under Section 162(a). He further determined that Section 1341 was inapplicable. As a result, petitioner could only deduct the repayment in the year it was made (1969) and could not carry it back to 1966, the year at issue.[2] In this refund suit brought by petitioner in the United States District

[2]Apparently, petitioner did not have sufficient income in 1969 to derive any advantage from the deduction available for that year. Individual taxpayers cannot take nonbusiness losses into account in determining the amount of their net operating loss deduction to be carried back or forward to other years. See Sections 172(c) and (d)(4).

Court for the Western District of Texas, the district court rejected petitioner's claim that he was entitled to an adjustment for 1969 under Section 1341. The court ruled that embezzled funds are not held under a "claim of right" and that petitioner did not have "an unrestricted right" to the embezzled funds within the meaning of Section 1341 (Pet. App. 5a-10a). The court of appeals affirmed (Pet. App. 12a-21a).[3]

Section 1341 was enacted in 1954 to alleviate certain inequities resulting from the operation of the "claim of right" doctrine under which amounts received under a claim of right must be included in income in the year received, even though they are subsequently returned because the claim was invalid. See *North American Oil* v. *Burnet*, 286 U.S. 417 (1932); *United States* v. *Lewis*, 340 U.S. 590 (1951); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 86, A294-A295 (1954). As an alternative to a deduction in the year of repayment, Section 1341 allows a reduction in the taxes for the repayment year equal to the increase in taxes in the year of receipt attributable to the inclusion in that year of the income item in question.

In order to claim the benefit of Section 1341, the taxpayer must show that the item of income was reported in a prior year "because it appeared that the taxpayer had an unrestricted right to such item." Section 1341(a)(1). The statutory phrase "unrestricted right" to income refers to income held under a "claim of right" (see

[3]The district court also held that petitioner's repayment of the embezzled funds was not deductible as a business expense because his occasional embezzlement activities did not constitute a "trade or business" (Pet. App. 4a-5a). Accordingly, the court upheld the government's position that the repayment of the embezzled funds gave rise only to a nonbusiness loss deduction under Section 165(c)(2) of the Code (Pet. App. 1a-12a). Petitioner did not question this aspect of the district court's decision in the court of appeals and does not seek review of it by this Court.

H.R. Rep. No. 1337, *supra;* Treasury Regulations, Section 1.1341-1(a)). However, it has long been established that an embezzler has no claim of right to embezzled funds. *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946). The courts have therefore consistently held that Section 1341 is not applicable to the repayment of embezzled funds. *Hankins* v. *United States*, 403 F. Supp. 257 (N.D. Miss. 1975), aff'd, 531 F. 2d 573 (5th Cir. 1976); *Yerkie* v. *Commissioner*, 67 T.C. 388 (1976). *Hauser* v. *Commissioner*, 29 T.C.M. 908 (1970).

Petitioner's principal contention (Pet. 7-8) is that in *James* v. *United States*, 366 U.S. 213 (1961), the Court overruled its earlier determination in *Commissioner* v. *Wilcox*, *supra*, that embezzled funds are not held under a claim of right. But petitioner misreads the import of *James*. In *Wilcox*, the Court held that embezzled funds did not constitute income to the embezzler because he had no bona fide claim of right to such funds. In *James*, the Court held that embezzled funds are income under the broad definition of Section 61 of the Code. However, it did not so hold on the ground that such funds are held under a claim of right but rather on the basis of the economic benefit derived by the embezzler from the embezzlement. Indeed, in *James* the Court reaffirmed its earlier conclusion in *Wilcox* that embezzled funds are not held under a claim of right (366 U.S. at 216). Thus, as the court below correctly recognized (Pet. App. 18a-19a), *James* does not hold that embezzled funds are held under a claim of right.[4]

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[4]Nor does *Healy* v. *Commissioner*, 345 U.S. 278 (1953) (Pet. 4-7), support petitioner's position that embezzled funds are held under a claim of right. The Court there (p. 282) simply reaffirmed its earlier decision in *United States* v. *Lewis*, *supra*, that "a mistaken claim is nonetheless a claim" for purposes of the claim of right doctrine. Petitioner, however, never had any claim, mistaken or otherwise, to the funds he embezzled.

Contrary to petitioner's first argument (Pet. 8-9), the decision below does not conflict with *Quinn* v. *Commissioner*, 524 F. 2d 617 (7th Cir. 1975). The application of Section 1341 was not at issue in *Quinn*. The only question there was whether the embezzlement of funds gives rise to taxable income where, in the same year the embezzlement occurs, the embezzler acknowledges an obligation to repay the funds. The court correctly held that actual repayment—not simply recognition of an obligation to repay—was necessary to create an offsetting deduction to the amount realized from the embezzlement. Although the court stated (524 F. 2d at 623) that James expanded the claim of right doctrine to include embezzled funds, this statement was not only erroneous but also was unnecessary to the decision because embezzled funds constitute income under *James* without regard to whether they are received under any claim of right.

Accordingly, it is respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

DECEMBER 1978

DOJ-1978-12